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The central bank policy between the price stability objective and promoting financial stability

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Abstract

The paper aims to emphasize the role of the monetary policy and the central bank's position concerning the financial stability in the new context created by the global financial crisis, and given that it pursues the price stability, as the primary objective. The analysis highlights the need to review the position of the central bank in order to promote a more proactive stance to deal with financial stability, beyond the traditional framework of regulation and supervision, but there is a risk of emerging conflicts derived from the pursuance of the primary objective (the price stability) while maintaining financial stability.

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Keywords: financial crisis; central banking; inflation targeting; governance; independence; non-standard monetary instruments, responsibility for financial stability

1. Introduction

Along with the outbreak of the global financial crisis in 2007, the "Great Moderation" period, characterized by a low macroeconomic volatility and a non-inflationary economic growth worldwide, has ended, and has begun a new

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stage of global transformation, for redefining the political and economic relations between countries, but also for restoring the priorities of the general policy to reduce the financial instability. On the one hand, the new macroeconomic framework underlines the importance of the clear and proper regulation, as the main condition for defense against the financial instability, and on the other hand, underlines the strengthened link between the financial stability and the macroeconomic policies, especially the monetary policy, to support it. Thus, it becomes obvious the increase of the Central Bank's responsibility, with the monetary policy as an element of the macroeconomic policies' mechanism.

The complex processes of expansion, liberalization and globalization of financial flows developed in the recent decades increasingly deepened the financial system, producing a widening gap between the financial economy and the real one, while the relationship between the financial and monetary stability (price stability) had complicated. Changes of the financial regimes (liberalization of financial flows) in most countries have made the financial factors, especially those related to the "boom-bust" cycle of credit or asset prices, to be generators of the economic fluctuations. Changes of the monetary regime during the "great moderation" were directed instead towards achieving monetary stability by keeping inflation and returns low, assuming that in this way would avoid the potential unsustainable development of the economy and would ensure stability of the financial system. In fact, the strong development of the financial sector weakened the ability of the inflation to report anomalies in economic activity development, while the furtherance of the monetary stability during the "great moderation" besides the fact that did not supported the financial stability but affected her, actually fostering speculative bubbles, given that, in a confident and optimistic background for businesses (especially for banks) was encouraged greater risk taking. In this context, it is necessary to reconsider the role of the central bank in terms of its primary objective of price stability, in conjunction with the promotion of the financial stability. This problem began to be raised especially after the crisis started in 2008. Although the central banks were those that protected the economies, they failed to support the recommencement of the economic recovery.

In this article we try to identify the new framework in which monetary policy can operate taking into account a reassessment of the role of the central bank given the increasing importance of the general objective of financial system stability, but also suspicions that central banks have allowed the appearance of conditions that led to the crisis. To better illustrate the research, the authors considered both a review of the literature on the relationship between financial and price stability, and a comparative analysis of how the major banks (European Central Bank - ECB the U.S. Federal Reserve - the Fed, and the Bank of England - BoE) relate to the issue of financial stability after the global financial crisis.

2. The changing role of central banks

The oldest central banks appeared at the end of the seventeenth century (Bank of Sweden in 1688, the Bank of England in 1694), followed by the Bank of France which appeared only in 1800 and other central banks that have been established by the end of the nineteenth century (Goodhart et al.1994). We mention, in order of their appearance, the central banks from Finland, the Netherlands, Portugal, Spain, Germany, Japan, and Italy. The number of central banks increased from 18 in 1900 to 161 in 1990 (Pringle et al.1993), most banks being relatively new, established since the mid-twentieth century. According to a study of the (Bank of International Settlements,2009) the last three central banks were established around the year 2000.

Predecessors of current central banks had completely different role than monetary policy, their main skill being to improve the government's ability to borrow money in times of war, many of them being established during some wars or immediately after their end (Clapham, 1944; Timberlake, 1993; Wilson 1957; Hamilton,1945). The central banks' roles reflected the history, and were created to meet the needs of those times. Meanwhile, older functions such as monetary policy are different now, compared to beginning periods. Initially, the main functions of central banks' early forms were the issuing of banknotes and governments' bankers (these regnant banks became the classic choice for governments' banking activity), and later some central banks (e.g. in Austria, France, Portugal and Spain) were established to rebuild the monetary stability and the currencies' credibility, the primary motivation being survival, and not necessarily wider macroeconomic issues. In time these regnant banks became bankers of the banking system and for economic reasons they provided loans for bank customers to cover their lack of liquidity, turning into lenders of last resort, but also in banking system supervisors, different function from the current one only and for pursuing their own economic interest and not the protection of the system as a national goal. The emergence of public objectives is related to the late nineteenth and early twentieth century, when the establishment of central banks was made for public reasons. The introduction of the gold standard confirmed the role of central banks to ensure the convertibility of national goods and led to the abandonment of commercial purposes. The economic crisis brought about by two World Wars and a changed view on the role of government in economic management led to the establishment of many central banks (as public institutions) and the nationalization of many central banks. Monetary policy has acquired other meanings by introducing the gold standard, the supervisory and regulatory functions were obvious and straightforward, and the changing role of government in the economy has created the function of economic development.

The period after the crisis started in 2007 is not the first time when the role of central banks has been revised. Such an approach has taken place after the Second World War, but periodically thereafter, whereas the objectives and instruments of central banks received new life.

The weakening of the Bretton Woods system efficiency in the ʾ60s highlighted the role of monetary policy to stabilize the economy, bringing it at least on the same rank with fiscal policy. The changes were most obvious in the '70s, years characterized by inflation and inflexible markets when central banks became independent, establishing monetary policy to ensure price stability. It was also introduced the exchange rate tool, and monetary policy aimed to give more flexibility for markets.

During 1980-2007, the central banks have enjoyed a growing credibility built on the positive results gained in this period: reducing inflation and maintaining it at low levels, alleviate recession episodes (the amplitude and the time). In this way, it was created the belief that monetary policy was the tool that was able to effectively reduce the economic fluctuations and set the necessary economic growth faster and more consistent, the central bank being considered the main or even the only institution that can fight with the inflationary phenomenon. Such beliefs have resulted in the formation of inflation targeting strategy that has spread around the world since 1990, and central bank independence was considered the condition to achieve such an objective.

After 2007, these qualities were affected, one of the major risks being the loss of central bank independence by many pressures on them to carry out activities that go beyond the institutional framework in which they worked before. (Cecchetti,2013) notes that the central banks currently face serious risk of being forced to solve virtually any problem of macroeconomic and financial stability, although these institutions cannot solve structural problems. Such a risk concerns including political pressure exerted on the monetary authority to become, under the pretext of the financial stability policy, a component of the financing system of government.

3. The relationship between price stability and financial stability

Some authors believe that price stability should be a sufficient condition for financial stability (Schwartz, 1995) or that price stability promotes financial stability (Bordo and Wheelock,1995). As (Bordo, 2007) argues that price stability is a prerequisite for financial stability. According to the same approach, it is claimed that financial and price stability reinforces each other on the long run. Empirically it has been shown that many financial crises were caused by significant changes in the price level (Bordo et al.2000), and most banking crises occurred during the recession that often followed episodes of high inflation (Gorton,1988); Calomiris and Gorton,1991). This gave a motivation to central bankers to pursue price stability objective, which is considered adequate for the stability of the financial system.

On the other hand, in many papers (Borio and Lowe,20002; Borio et al.2003, Blinder,1988) it is pointed out that the view that price stability is beneficial for financial stability must be reversed. This idea is argued by the fact that the success of maintaining low inflation may induce a too optimistic view on the future development of the economy and the false perception about safety may excessively increase assets value. Based on this reasoning, we can conclude that stable inflation at low levels can make the financial system more vulnerable.

Another observation, which confirms the previous statement is that made by Japan's central bank governor, (Shirakawa, 2012): “obsessive focus on the stability of consumer prices in the short run as a mean to economic stability will actually have the reverse effect of increased instability”, the financial system becomes unstable, and by keeping expectations on long-term economic stability, increased indebtedness and imbalances between the maturities of assets and liabilities of financial institutions are stimulated.

Experience demonstrates that the relation between financial and monetary stability is inconsistent: sometimes monetary stability promoted financial stability, sometimes, it embrittled it but concern over central bank's role in promoting financial stability is still an open issue.

4. General remarks on the central bank's role in promoting financial stability

Every economic policy has its specific objectives and instruments, but financial stability policy is rather vague, because there is no clear definition of financial stability and precise means of measurement. The objective of financial stability cannot be clearly formulated and formalized, as long as the targets are not well defined, such as price stability is formulated through inflation targeting strategy. Such a relationship is reflected in the sphere of accountability on monetary policy and financial stability policy. While the responsibility for monetary policy and its control belongs to a single institution, i.e. the prerogative of the central bank, the responsibility for financial stability and control for the tools for this area are usually distributed among several institutions.

Based on experience and different views on the role of central bank in promoting financial stability, one can summarize two general streams of thought on this topic. One is that the central bank should conduct proactively towards financial stability by extending the objectives of monetary policy so as to include financial stability (Eichengreen et al.2013) On the other hand, another school of thought argues that financial stability should be an objective by itself, followed either by an institution specially created for this purpose or by several institutions, cooperating, thus highlighting the difference between monetary policy and financial stability policy (Svensson,2013).

(Smaga,2013) emphasizes that, in principle, the degree of involvement of central banks in promoting financial stability refers to certain conditions:

- It has a legal basis on promoting financial stability, which is provided as a general objective in the statute of the central bank;
- It has its own definition of financial stability;
- It uses a set of indicators of financial stability;
- It performs stress tests;
- It publishes reports on financial stability – to contribute to the stability of the financial system, to strengthen cooperation between key institutions and enhance the transparency of the actions taken to promote financial stability;
- It contributes to the operation of the payment system in the economy;
- It has a role in prudential supervision.

(Oosterloo and de Haan, 2003) have asserted that most of the central banks have no official definition for the financial stability or for the systemic risk, and the responsibility of these institutions regarding the financial stability is not explained in legal terms, but in general terms, as *contributing*, *supporting* the financial stability or as an obligation to ensure the proper functioning of the payment system. The study reveals that the publication of either a Financial Stability Report or sections into the Annual Reports on this subject can be considered as the main manner for the fulfilment of the central bank'mandate in promoting financial stability.

According to (Borio,2011), prior to the global financial crisis, the central banks define the relationship between financial stability and monetary policy based on four statements:

- The price stability is a sufficient condition for macroeconomic stability - if the central bank manages to ensure the price stability on the short-term (two years), in the absence of the exogenous shocks, then the economy can operate without any disturbances, considering that the price stability represents the best contribution of the monetary policy to the macroeconomic stability. This concept was specific to the "Great Moderation" period and it underpinned to the adoption of inflation targeting strategy.
- There is a distinct separation between the financial stability and monetary stability functions. The central bank, as the lender of the last resort and liquidity provider, is considered the "treasurer" of the financial crises occurred, but there is a decoupling of these two functions regarding the crises prevention: monetary policy would ensure the price stability while the regulation and supervision policies would ensure the financial stability.
- The interest rate, as the monetary policy instrument, is sufficient to influence the economic activity, the only operational instruments being the short-term interest rates and the expectations regarding its future evolution.

- If each central bank would respond by its policy to the needs and problems of their own country, then the global monetary stance would be appropriate. This idea of managing the internal problems is a version of the microprudential approach to the financial stability: if each independent institution (in this case, each country) is “healthy”, then the entire financial system (in this case, the world economy) will be safe and sound.

The global financial crisis has changed the landscape in which central banks operate: before 2007 the inflation targeting was considered the only and the best solution provided by a central bank for the macroeconomic stability objective, but after the global financial crisis, the central banks have been subject to a strong pressure concerning its involvement in adjusting the functioning of the financial markets.

5. The central banks' experience in managing the global financial crisis

At the onset of the crisis, the central banks have responded by using the conventional measures, aggressively reducing the policy interest rates to prevent the risk of turning the disinflation into deflation phenomenon. Meanwhile, faced with a blockage in the interbank market, the major central banks (Fed, BoE, ECB) had to take direct charge of redistributing liquidity to meet the banks' needs. After Lehman Brothers shock propagation (in 2008), the crisis deepened, which required additional and special measures - unconventional monetary policy measures. The much-criticized decision taken by the ECB, that of raising the interest rates by 25 basis points, was then followed by a reduction of 50 basis points, in October, after the Lehman Brothers' bankruptcy. Fed has also asserted for a “close-to-zero interest rate” strategy, in summer 2010, before deciding, finally, a second wave of *quantitative easing*, in late of August 2010. In spring 2011, the ECB and the Fed restarted to announce the crisis-exit strategies. ECB began to normalize its monetary policy, increasing their representative interest rates by 25 basis points, in April and then in July, while in November and December to fall again by 25 basis points. The Fed position remained reticent, limited to the exposure of the different stages for exiting from the crisis. The deeper than expected economic recession led central banks to adopt accommodative monetary policy.

The diversity of the using the non-standard monetary policy measures are due to the differences regarding the financial systems (in the U.S. and UK, the financial system is dominated by the capital market, while in Europe, the financial system is dominated by the banking sector), the institutional framework and also regarding the perception of the risk' evaluation undertaken by the central bank. In the Euro Area, the ECB attempted to correct those components of the monetary transmission mechanism that were most affected. On the other hand, the strategy applied in the U.S., was a blur of the boundary between the monetary policy and fiscal and financial policies. For Euro Area, such a framework would cause an increasing risk for altering the independence of the monetary authority.

Central banks underpin the economic activity both in the United States and in Europe. Given the almost non-existent leeway to cut interest rates, their main resource is to multiply the non-standard monetary policy instruments, the first consequence of that behaviour being an increasing of the size of the central bank's balance sheet. However, the content of the measures differ from one central bank to another. Bank of England and Fed primarily aim to reduce the long-term interest rates in order to improve the financing conditions and to stimulate the private investment.

In the Euro Area, the objective is also to reduce the credit cost, but the action is focused on the banking sector, the main source of funding for the non-financial corporation in the Eurozone. However, by the announcement of the government securities acquisition program in the secondary market (Outright Monetary Transactions), on September 6, 2012, the monetary policy in the Euro Area experienced a turning point in the sense that the ECB has no limits on its interventions in bond markets. This decision is taken to ensure the monetary policy transmission mechanism in the Euro Area countries. Despite these measures, the economic recovery in the United States is weak and the economic activity in the euro area and UK is slow again. On the one hand, the developed economies, including the United States, are probably not completely out of the liquidity trap, which limits the effectiveness of the monetary policy. On the other hand, the stimulation made by the monetary policy is not enough to compensate an increasingly restrictiveness of the fiscal policy, especially in the Euro Area and UK.

ECB has chosen to support banks, providing liquidity in the banking system and not applying the quantitative easing, like the Fed or BoE, which is a measure directed toward providing monetary incentives when the interest rate is close to zero. The motivation for such a decision is that the banking sector is dominant in the Eurozone and so it should ensure continuously the financing to the private sector. The ECB did not intend to intervene directly in the assets market, but to ensure both a proper functioning of the monetary transmission mechanism in the Euro Area and correcting the malfunctions of various segments of the financial market.

The implementing of the conventional and unconventional measures of monetary policy, at the beginning of the global financial crisis and later, has suppressed both the financial deterioration and the economic activity restraining. However, the central bank's role was that of providing time to adopt adjusting measures for more general crisis consequences. They are not the solution to the crisis consequences, but for providing time.

In the context of the global crisis, one of the consequences derived from the measures applied by the central banks, is the expanding of their responsibility to the political area. The decision to implement quantitative easing measures by purchasing of some sort of securities looks like a subsidy of those who are in debt, requiring more political and democratic control. Also, the responsibility of the central banks shifts from the carrying out the monetary policy to the financial stability restoring. Such an extended operating area means an increasing of the central banks' constraints, by affecting their independence.

The consequences induced by the global financial crisis have shown not only that the restoring of the financial stability involves high costs borne primarily by central banks, but also that the standard model regarding the central bank's role, applied during the "Great Moderation", should be reconsidered based on the interlinkages between monetary policy, fiscal policy and regulatory policy. (Ceccheti,2013) drew attention to these relationships:

- the monetary policy influences the fiscal policy through the central bank's balance sheet;
- the fiscal policy influences the monetary and regulatory policies through the government options regarding its financing sources;
- the monetary policy, through its influence on balance sheets, influences the regulatory policy;
- the regulatory policy, through its dealing with the sovereign debt, influences the fiscal policy;
- the regulatory policy influences the monetary policy by modifying the borrowing costs.

Besides these observations, in the post-crisis environment, it is noticed the need for implementing the macro-prudential policies aimed at the financial stability objective, as limiting the systemic risk, and which are designed for the financial system, thus including also the interactions between the real economy and the financial economy.

The economic policies' instruments aimed at promoting the financial stability (those specific to the fiscal policy, monetary policy, regulatory policy, etc.) can be brought together under the umbrella of macroprudential policy. One of the most important tools that convey information on macroprudential policy is considered the Financial Stability Report, a document published by most central banks. Its publication is the specific responsibility of a central bank, and that is an argument for that institution to play a key role in the macroprudential supervision.

On the other hand, the central bank involvement in promoting the financial stability must be established between certain limits imposed by the mandate of the price stability. Such a conflict is especially noticeable when it plays the role of lender of last resort. Therefore, a challenge for the next period is that to disentangle the central bank's mandate regarding the financial stability.

Conclusions

More and more central banks began to expand their responsibilities, assuming the role of stabilizing the financial system, turning somehow to the reason for which the first central banks have been established, namely for government financing during crisis (specifically, for war-funding).

The conflict between the price stability and the financial stability is also reflected by the different time horizon for which they are designed. Monetary policy is usually set for a period of 2-3 years, which is consistent with the economic cycle, while the risks and imbalances in the financial system accumulate during a longer period, causing the so-called financial cycle, which can contain several economic cycles. A solution to this discrepancy could be widening the timescale for the price stability objective.

Many central banks pursue, in addition to the price stability objective, the economic development, and therefore they take certain measures concerning the use of resources, which could lead to the failure of stabilizing the short-term inflation and maintaining a sustainable resource use in the long-term. Taking into account the financial stability as a supplementary objective and if the economic and financial cycles go in different directions, then it could be generated conflicts between the stabilizing prices and the resource management, as short-term objectives, and financial stability, as long-term objective.

One of the major challenges for central banking refers not only to the potential conflict between the price stability and the financial stability, but also to the broadening of the operational framework by actions performed by central banks toward the restoring of the financial system. If, theoretically, there is the concern that by expanding the central bank's balance sheet, it will be affected its primary objective, the experience of the recent years shows that the real risk of such actions is the impairment of the central bank's independence, because an excessive expansion of the central bank's responsibilities means a greater involvement in the political arena.

For central banking, the financial stability remains of fundamental interest. The central banks should ensure a balance between maintaining the price stability, as its primary objective, and promoting the financial stability, which is a more general objective. The latter is found within the area of concerns of those institutions regarded as "safety net". With globalization, it has become a prerequisite for promoting the financial stability that the central banks must collaborate with other institutions and financial authorities to exchange information on common interest for an effective action to prevent and to manage potential crises.

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